

City Manager's Office 17575 Peak Avenue Morgan Hill, CA 95037 TEL: 408.779.7271 Fax: 408.779.1592 www.morganhill.ca.gov

April 29, 2016

Subject: FISCAL YEARS 2016-2018 RECOMMENDED BUDGET

Honorable Mayor and City Council Members,

On behalf of my Morgan Hill teammates, it is a privilege to present to you and the community the Recommended Fiscal Year 16-18 Biennial Operating Budget and FY 16-17 through FY 21-22 Capital Improvement Program Budget (CIP). This is the first year of the transition to a two year operating budget cycle and six year CIP. The biennial budget consists of two separate budgets that the Council will consider for adoption. Prior to the conclusion of the FY 16-17 annual budget, the Council will be provided an update on revenue assumptions, fund balances, and possible amendments to the FY 17-18 (or second year) annual budget. A sixth year has been added to the CIP to ensure a five year spending plan is maintained. The budget documents are the product of many employees working in a collaborative manner to align resources and propose service level enhancements that are consistent with the City Council's and community's priorities, while continuing to maintain fiscal responsibility. In implementing the Council's budget, our team strives to advance our organizational values of teamwork, customer service, innovation, meeting challenges, and professional development. I want to acknowledge and thank all of them for their efforts to improve the community we serve. It is an honor to work with such a dedicated, community-focused team of professionals.

City Council Priorities and Goals

The budget process commences in January with the City Council adopting its priorities, goals, and strategies for the organization and community. The Council's ongoing priorities include:

- o Enhancing public safety
- o Protecting the environment
- o Maintaining fiscal responsibility
- o Supporting youth
- o Fostering a positive organizational culture
- o Preserving and cultivating public trust

In addition to the City Council's priorities, five specific Focus Areas were recognized by the Council that will require significant resources:

- o Planning our community
- o Developing our community
- o Enhancing our services
- o Improving our communication
- o Participating in regional initiatives

Furthermore, consistent with the City's previous community engagement and commitment to understanding resident satisfaction and service priorities, the City of Morgan Hill commissioned Godbe Research to conduct a telephone survey to assess resident satisfaction and priorities for City services. The results show constituents are highly satisfied with their quality of life and the services the City provides. An overwhelming majority of 90% of respondents rate Morgan Hill's quality of life as "excellent" or "good." And among several other very positive findings, 92% rate Morgan Hill "excellent" or "good" as a place to live.

Residents identified the following quality of life service priorities:

- Rapid response to 9-1-1 emergencies
- Maintaining the number of police officers on neighborhood patrols
- Maintaining crime prevention and investigation programs
- Maintaining fire protection
- Maintaining city streets and roads, and repairing potholes
- Maintaining the long-term financial stability of the City

To learn more from our residents, the City has recently begun engaging the community further to obtain additional feedback about Morgan Hill's quality of life needs and to ensure as many people as possible have an opportunity to share their views. This includes a survey, meetings with community organizations (Chamber of Commerce, Jackson Oaks Association, etc.), and another survey in July. Results from both the previous and current surveys can be found in the budget document as well as on the City's website.

This priority based budget strategy ensures that the Council's and community's priorities are the guiding principles for developing the biennial operating budget and capital improvement program with the goal of enhancing City services. The proposed budget strives to achieve this goal in a cost effective manner and at all times, long-term financial sustainability is the focus. This includes ensuring that revenues and expenditures remain in balance for ongoing expenditures and one-time expenditures are proposed as resources allow. The proposed budget also continues to take incremental steps to address the backlog of

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unfunded or deferred infrastructure and maintenance needs as has been discussed and documented over the past two years.

With the Council's and community's priorities in mind, each operating department proposed enhancements --otherwise known as "decision packages"--which they believed would advance the aforementioned priorities. The decision packages were categorized as ongoing (e.g., personnel) or one-time investments (e.g., capital improvement project) and evaluated to determine which would best meet the community's needs within the City's financial resources. Highlights of the resulting recommendations follow with more detailed explanations in the respective department narratives. Each decision package may advance more than one Council priority, though each has been included only in its most significant priority.

The proposed biennial budget continues to recommend aligning new ongoing service enhancements with ongoing funds to support those additions. In addition, the budget recommends that one-time funds be strategically invested to meet one-time needs, such as addressing a portion of the City's needed but unfunded infrastructure and maintenance needs, setting aside or prefunding obligations, and investing in technology to efficiently and effectively deliver a high level of service to our community.

The following outlines the decision packages that have been included in the proposed budget. It is important to realize that these are funded through a variety of sources and not just solely by the General Fund.

Enhancing Public Safety

- Hire a full-time Public Safety Dispatch Supervisor in the Police Department which was eliminated during the economic downturn to supervise and manage the day-to-day operations of the communication center and to ensure the center's operational effectiveness \$158,000 (ongoing)
- Purchase Patrol rifles specific to each officer for personalization of weapon \$65,000 (one-time)
- Purchase trunk vaults to secure Police weapons \$9,600 (one-time)
- Purchase Police Department flashlights and start-up supplies for Traffic Division motorcyles -\$10,800 (one-time)
- Implement a dataworks interface with the County's Records Management System enabling booking photos to be registered in a countywide booking system \$5,000 (one-time)
- Purchase a used reserve fire engine as a back up to the City's existing Fire Department fleet -\$35,000 (one-time)
- Replace garage door openers for the El Toro and Dunne Hill Fire Stations as their useful life has been exceeded \$12,000 (one-time)

Protecting the Environment

- Include \$6 million in the CIP for agriculture preservation as previously directed by the Council
- Continue water supply planning to evaluate ways to maintain (and potentially increase) the capacity for water storage in the Llagas groundwater basin \$100,000 annually (over two fiscal years)
- Fund a part-time teammate to assist with inspecting outfalls in the community creeks to help identify sources of pollution and ensure that pollution is stopped before it enters the creeks \$1,900 (ongoing)

Maintaining Fiscal Responsibility

- Increase the General Fund investment for street improvement projects \$250,000 annually (ongoing for three years)
- Continue to address the City's unfunded Other Post Employment Benefits (OPEB) liability by contributing to the Trust Fund in the amount equal to the Annual Required Contribution (ARC) so that the unfunded liability decreases over time - \$300,000 annually (all funds)
- Meet the Pension Stabilization Account funding goal of \$500,000 to ensure the City is prepared for any unanticipated PERS rate changes \$300,000 (one-time all funds)
- Set aside funds for Firearms Replacement program \$10,000 (ongoing)

Supporting Youth

- Initiate a three year effort to install decorative crosswalk near community schools as part of the City's safe routes to school CIP \$100,000 annually (over three fiscal years)
- Support Downtown Investment Strategy and provide additional park spaces by initiating the construction of 3 Downtown parks - CIP \$4,051,000
- Collaborate with the community for the design and construction of a \$4 million inclusive playground that is envisioned to be substantially funded through donations \$550,000 (one-time)

Fostering a Positive Organizational Culture

- Purchase WorkFit height adjustable work stations to allow the Police Department's Records Team to sit or stand while working at their desk \$5,000 (one-time)
- Investment in City's Information Services infrastructure by continuing exchange server upgrade and

- implementation of workstation virtualization which would provide a more highly flexible and secure workstation delivery model \$565,000 over two years
- Paint the exterior of El Toro Fire Station to protect the fire station from further damage due to age -\$15,000 (one-time)
- Re-roof Dunne Hill Fire Station as the old roof has reached its useful life and started leaking into the living space of the fire station \$46,000 (one-time)

Preserving and Cultivating Public Trust

- Add an accounting manager position to enhance service delivery and internal control procedures -\$143,000 (ongoing)
- Purchase electronic Form 700 and campaign finance filing software system \$6,000 (ongoing)

Planning Our Community

- Hire a GIS/Land Use Data Administrator responsible for the design, operation, and administration of Citywide GIS infrastructure \$159,000 (ongoing)
- Establish an Economic Development Internship program \$22,000 (ongoing)

Developing Our Community

- Hire a Senior Project Manager to advance recreation, parks, and community capital projects, while decreasing contractual services expenses \$189,000 (ongoing). Note that expense is entirely offset by savings in contractual services
- Hire a Public Works Inspector to expedite development and CIP projects while decreasing contractual services expenditure – \$152,000 (ongoing). Note that expense is entirely offset by savings in contractual services
- Hire a full-time Municipal Services Assistant to provide support for the Building and Code Compliance divisions - \$104,000 (ongoing). Note that expense is offset by a \$29,000 savings in part-time expense

Enhancing Our Services

• Purchase OpenCounter Economic Development online software to make City Hall more accessible and user-friendly - \$25,000 (one-time)

- Continue to provide high level of service for our older adults and ensure Morgan Hill seniors are
 able to receive support through County, State, and Federal programs by providing additional
 funding for senior services case management \$10,000 (ongoing)
- Install pathways and seating at the dog park \$18,000 (one-time)
- Invest approximately \$2 million over two years in future building replacement fund for improvement projects (e.g., CRC locker room improvements, CRC fitness equipment replacement, Police Department carpet replacement)
- Fund temporary, part-time support to provide ongoing administrative maintenance services -\$23,700 (ongoing)
- Fund temporary, part-time teammate to clean and support the City's public art programming -\$6,600 (ongoing)
- Fund temporary, part-time project support in the City Manager's Department to assist with significant projects and initiatives \$50,000 (ongoing)

Improving Our Communication

- Conduct a comprehensive internal and external Communications Assessment to evaluate the effectiveness of our current communication efforts \$25,000 (one-time)
- Implement lobby and signage improvements at the Morgan Hill Dennis Kennedy Aquatics Center -\$28,000 (one-time)
- Install park display boards to increase citywide communications and engagement \$8,800 (one-time)

In addition, at the Council's goal setting workshop in January, there were community requests and Council discussion about enhancing animal control services and potentially partnering with the Morgan Hill Historical Society to operate and improve Villa Mira Monte. The Police Department has further evaluated our level of animal control services and will be providing a report on May 4 to update the Council and receive any further direction. If additional resources above and beyond those recommended in the proposed budget are desired by the Council, the appropriate research will be completed or funds appropriated prior to the Budget Workshop on May 20.

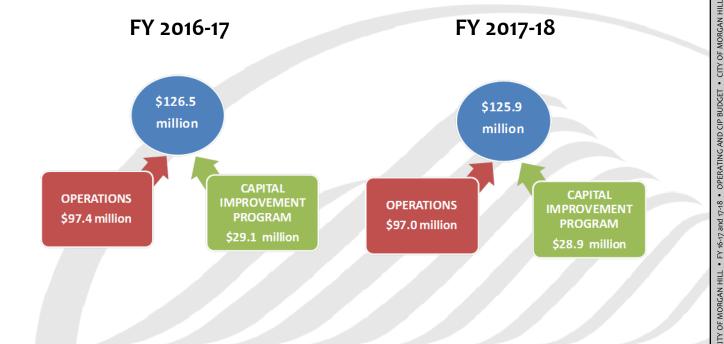
For the Historical Society's request, we are planning to make a recommendation to the Council as part of the Parks, Recreation, and Trails Master Plan report in September 2016. As discussed at the Council's workshop, the Historical Society's request will need to be prioritized with other park and recreation projects as funds are limited. The City's Community Services Director has been working with

representatives of the Historical Society since February. At the April 19, 2016, Parks and Recreation Commission meeting, the Commission reviewed the proposed CIP and recommended that Villa Mira Monte be added at this time. Staff continues to recommend that this decision be made once the Master Plan is complete and accordingly no project costs have been added to the CIP.

Also included in the Council's workshop discussion were several major studies and initiatives that are underway. These include developing a Public Safety Master Plan, creating an Economic Development Blueprint, evaluating the effectiveness and efficiency of our development services processes and organizational structure, updating the Parks, Recreation, and Trails Master Plan, updating the Water Master Plan, updating the Wastewater Master Plan, and developing a long-term solution for our affordable housing administration. In each case, the adoption of the FY 16-18 operating and capital budgets will occur prior to the conclusion of the necessary work. As a result, it is envisioned that service enhancement budget amendments may be necessary in the months following budget adoption. This could include, but not be limted to, additional capital projects, organizational structure changes, and enhanced services that advance the Council's and community's quality of life priorities.

Budget Overview

The total Recommended Biennial Budget is \$126.5 million in FY 16-17 and \$125.9 million in FY 17-18 as shown below. This includes all expenditures in two major categories; 1) operations and 2) capital projects. A detail of each project description and funding requirements for FY 16-17 and FY 17-18 can be found in the accompanying operating departments and Capital Improvement Program sections of this document.



General Fund

The General Fund (GF) is the City's most visible fund because it accounts for many of the City's services that most residents relate to including police, fire, recreation, street maintenance, municipal governance, and administrative services. In the Recommended FY 16-18 Biennial Budget, over 79 percent of General Fund revenue will be derived from four sources 1) property tax of \$10.0 million for FY 16-17 and \$10.1 million for FY 17-18, 2) sales tax of \$8.8 million for FY 16-17 and \$9.2 million for FY 17-18, 3) recreation revenue of \$6.9 million for FY 16-17 and \$7.3 million for FY 17-18, and 4) Transient Occupancy Tax (TOT) of \$2.7 million for FY 16-17 and \$2.8 million for FY 17-18. The remainder of revenue is generated by other charges for services, grants, and transfers. Property tax revenue for FY 16-17 and FY 17-18, based on the most recent information provided by the County of Santa Clara, is projected to increase by 10 percent and 12 percent, respectively, compared to the FY15-16 Adopted Budget as newly built housing units are added to the assessor's roll, Proposition 8 temporary reductions granted by the County Assessor's Office during the Great Recession are gradually restored, and property values increase. Subsequent years are estimated to increase by 3%, 3.5%, and 3.5%.

Sales tax revenue, is estimated to decrease approximately 4 percent in FY 16-17 compared to FY 15-16 year end projection, primarily due to ending of triple-flip and true-up payment to occur in FY 15-16. For FY 17-18, sales tax revenue is expected to increase by 4 percent compared to FY 16-17, largely due to continued moderate economic growth forecasted for the region and new business growth. Subsequent forecast years assume an average annual growth of approximately 4 percent. From a property and sales tax perspective, it is important to understand that the City only receives a small portion of the total taxes paid by residents, businesses, and visitors as depicted in the following images.





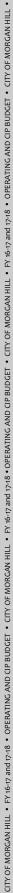
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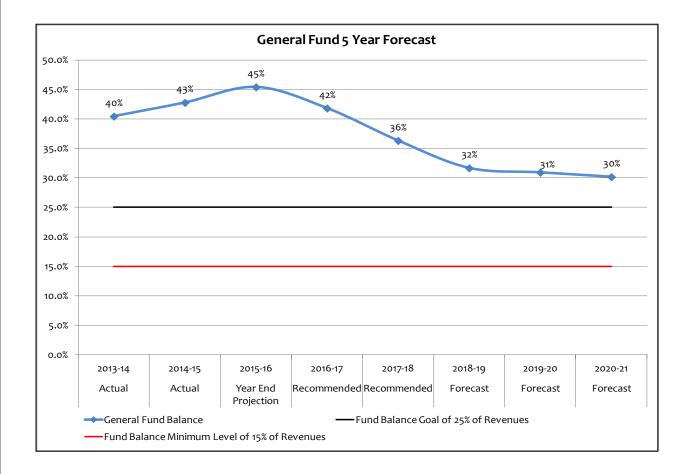
Recreation revenue from membership sales, program registrations, and facility rentals continue to maintain their high levels, with a noticeable increase expected to start in the second half of FY 17-18 due to a scheduled fee increase. To ensure the City has the resources to operate and maintain its recreation facilities, the City's membership rate strategy is to increase rates once every three years (January 2018, 2021, etc). The proposed budget includes rate increases for Aquatics Center daily admission, room rental at Cultural and Community Center (CCC) and Centennial Recreation Center. Furthermore, additional programs are planned for adult sports leagues, Older Adult Services, and fee based events at the CCC. The City's diverse programs and activities have grown in the past years and community feedback indicates interest in other types of sports and programs. The proposed increase in rates and additional programs and services are projected to generate additional net revenue of approximately \$115,000 per year.

Finally, the City is experiencing a historic high level of revenue from TOT due to a strong economy, the regional use of the City's Outdoor Sports Center and Aquatics Center, and a burgeoning tourism economy. Based on current year activity levels, TOT is estimated to reach a new high of \$2.7 million in FY 16-17 and \$2.8 million in FY 17-18 with the increase coming from new hotels such as La Quinta, a 104-room hotel and a planned 60-room boutique hotel in Downtown. The table below summarizes the major General Fund revenue by category compared to FY 15-16.

	FY 15-16	FY 16-17			FY 17-	-18	
	Year End			% Change			% Change
Revenue	Projection	Re	commended	vs FY 15-16	Red	commended	vs FY 16-17
Property Tax	\$ 9,944,000	\$	9,961,000	0.2%	\$	10,114,000	1.5%
Sales Tax	9,186,200		8,819,767	-4.0%		9,151,500	3.8%
Recreation	6,625,711		6,862,661	3.6%		7,262,583	5.8%
тот	2,400,000		2,684,700	11.9%		2,827,050	5.3%
Other	6,233,552		6,114,828	-1.9%		6,027,047	-1.4%
Transfer	1,597,317		1,627,581	1.9%		1,655,508	1.7%
TOTAL	\$ 35,986,780	\$	36,070,537	0.2%	\$	37,037,688	2.7%

Overall, the City's General Fund is expected to remain in a stable position and be operationally balanced over the forecast period. The expenditures in the Recommended Biennial Budget are forecasted to exceed the projected revenues by \$1.2 million in FY 16-17 and \$1.7 million in FY 17-18 as the City continues to strategically invest accumulated fund balance in the community. Revenues and expenditures are forecasted to be in alignment in each year beginning FY 19-20. As evidenced by the General Fund 5 Year Forecast as shown below, GF reserves remain above the Council's 25 percent policy during the entire five year forecast.





From a dollar standpoint, the GF's fund balance is forecasted to decrease from \$16.3 million at the conclusion of FY 15-16 to \$12.5 million by the end of FY 20-21 primarily due to the aforementioned additional investments in the City's street infrastructure, gradually restoring staffing levels in high priority areas, and addressing unfunded OPEB and PERS liabilities (all of which are further explained in subsequent sections of the Budget Message).

General Fund 5 Year Forecast

(in millions of dollars)

(III IIIIIII or dollars)						
	15-16	16-17	17-18	18-19	19-20	20-21
	YEP	Rec	Rec	Forecast	Forecast	Forecast
Beginning Balance	\$15.0	\$16.3	\$15.1	\$13.4	\$12.3	\$12.4
Revenues/Transfers In	36.0	36.1	37.0	39.0	40.2	41.5
Expenditures/Transfers Out*	(34.7)	(37.3)	(38.7)	(40.1)	(40.1)	(41.4)
Ending Balance	\$16.3	\$15.1	\$13.4	\$12.3	\$12.4	\$12.5
GF Fund Balance/Reserves (%)	45%	42%	36%	32%	31%	30%
Operating Margin	\$1.3	\$(1.2)	\$(1.7)	\$(1.1)	\$0.1	\$0.1

^{*}Includes Anticipated Salary Savings

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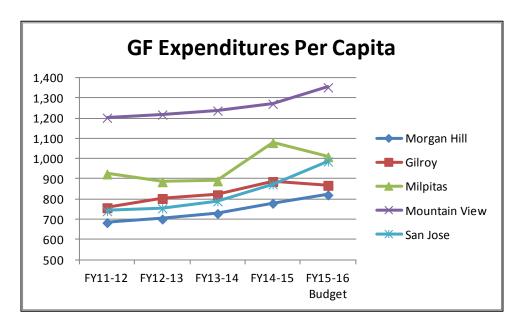
From a spending perspective, the Council has discretion on how to spend approximately \$24.2 million of the \$36.1 million in GF revenue. This is due to the fact that over \$11.9 million in GF revenue is related to a specific service and can only be used to provide that service (e.g. recreation services). The Biennial Budget recommends that the Council allocate its discretionary funds as depicted in the following chart. As demonstrated, public safety continues to be the number one priority as 75 percent will be used for Police and Fire services. The remaining 25 percent of discretionary revenue is appropriated to pay for economic development, finance, human resources, City Clerk, recreation services, environmental services, street, parks, public facilities, Downtown maintenance, City Attorney, and City Manager services.



		Less Dept	Less		Percent of
Department	Total Costs	Revenues	Transfer In	Net Costs	total
Police	\$ 15,165,030	\$ (950,669)	\$ (100,000)	\$ 14,114,361	54.7%
Fire	5,288,996	(268,397)	-	5,020,599	19.4%
Administration	4,358,319	(1,991,198)	-	2,367,121	9.2%
Pavement Rehab CIP	1,000,000	-	-	1,000,000	3.9%
Recreation & Community Services	7,499,482	(6,762,818)	(75,000)	661,664	2.6%
Street Maintenance	2,064,401	-	(1,452,581)	611,820	2.4%
Economic Development	467,000	-	-	467,000	1.8%
SVRIA Public Safety	290,000	-	-	290,000	1.1%
Downtown Maintenance	241,610	-	-	241,610	0.9%
Park Maintenance	200,000	-	-	200,000	0.8%
OPEB	166,593	-	-	166,593	0.6%
PERs Rate Stabalization	166,593	-	-	166,593	0.6%
Environmental Programs	348,754	(203,902)	-	144,852	0.6%
Code Compliance	135,689	-	-	135,689	0.5%
Pedestrian Safety	100,000	-	-	100,000	0.4%
Congestion Management	75,219	-	-	75,219	0.3%
Future Replacement - Council Chamber Building	29,362	-	-	29,362	0.1%
Long Range Planning	23,100	-	-	23,100	0.1%
Building Maintenance - El Toro Youth Center	9,781	-	-	9,781	0.0%
Cable TV	48,258	(50,456)	-	(2,198)	0.0%
TOTALS	\$ 37,678,188	\$ (10,227,440)	\$ (1,627,581)	\$ 25,823,167	100%

The General Fund expense budget is \$37.7 million and \$38.9 million for FY 16-17 and FY 17-18, respectively. FY 16-17 salaries and benefits increased 8 percent or \$1.4 million from last year amended budget primarily due to scheduled pay increases per MOU, pension and health premium costs, additional funding of 3 full-time equivalents (FTEs), and non-benefitted part-time positions including the recently approved State minimum wage increases. For FY 17-18, salaries and benefits increased 4 percent or \$0.8 million compared to Recommended FY 16-17 primarily due to aforementioned reasons but without new FTE. The non personnel budget for the General Fund in the Recommended Biennial Budget increased 2 percent or \$329,000 for FY 16-17 compared to FY 15-16 Amended Budget mainly due to an increase in the annual General Fund investment for street improvement projects from \$750,000 to \$1,000,000, funds set aside to address the City's unfunded OPEB and pension liabilities, and service enhancements, partially offset by reduction in supplies and services. Non personnel budget for FY 17-18 increased incrementally, 2 percent or \$379,000 from FY 16-17 mainly due to overall cost inflation factor. With this being said, it is important for the Council and community to understand that the City is not yet in the financial position to address its aging public infrastructure (streets, facilities, parks) in an ongoing manner that significantly reduces its deferred maintenance backlog or decreases the level of annual decline. As demonstrated below, Morgan Hill has the lowest General Fund expenditures per capita compared to a sample of surrounding cities.

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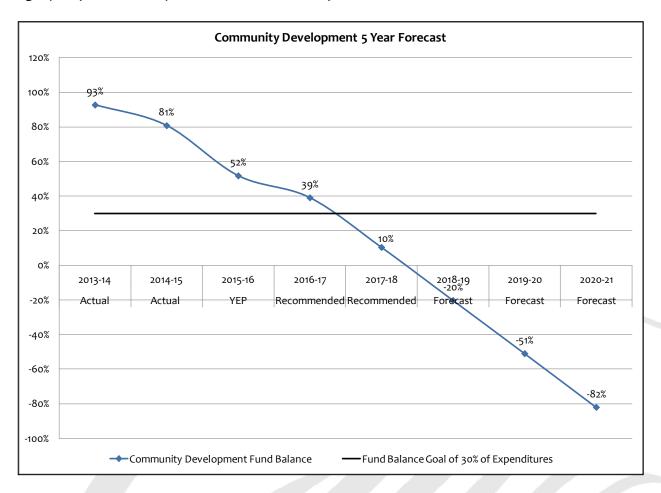


As the GF Reserves have accumulated to a healthy level resulting from prior Council actions and better than expected revenue growth in the past few years, it is prudent to continue the Council's tradition of using excess reserves to invest in the community. The FY 16-18 Biennial Budget recommends the use of GF reserves to increase the annual GF investment for street improvement projects to \$1,000,000 from \$750,000, for an additional investment of \$500,000 in the two year budget cycle. In addition, to ensure future financial stability of the City operations, the Budget calls for an expedited repayment schedule of SVRIA costs for the infrastructure, consoles and radios for the Fire and Police department. The initial cost of approximately, \$1,000,000, was funded by an advance from the Equipment Replacement fund. The plan is to have the costs repaid within three years or by FY 18-19, instead of the prior repayment schedule of ten years. An additional funding of \$300,000 in FY 16-17 to the "PERS Stabilization Account" is also included in the Recommended Biennial Budget. With the proposed funding, the Account would have a balance of \$500,000 that could be used to mitigate the wide swings of PERS rate increases and allow for the prepayment of unfunded pension obligations. With the aforementioned used of resources, the GF Reserve is projected to remain above Council's reserve policy in each year of the five year forecast as previously stated.

Community Development Fund

The Community Development Fund is a special revenue fund that is entirely supported by fees paid from developers and residents for planning, building, and engineering services. This fund has experienced noticeable fund balance growth during the past few years due to the surge in building activity resulting from the backlog of housing allocations and a slow resurgence of commercial and industrial development.

However, the fund began to tap into its reserve in the current year mainly due to large projects undertaken such as the General Plan Update and the purchase and implementation of the new permitting system, TRAKIT. The fund is forecasted to continue to be structurally imbalanced in the Recommended Biennial Budget requiring significant use of its reserves to cover recommended expenses. The fund reserve is projected to drop below the Council's 30 percent reserve level policy if all assumptions (both revenue and expenses as described below) hold true. The structural imbalance will continue and the fund is estimated to deplete its fund balance and rely on support from another fund. To address this fact, the Community Development Department's FY 15-16 work program includes measures to complete and implement an updated fee study with plans to present to City Council an updated fee schedule in the summer 2016. If the Council decides to revise the fees, the 5 year forecast will be updated accordingly. The fee update recommendation will be made in conjunction with service level enhancements being evaluated to ensure high quality services are provided to our community.



The Community Development Fund is an economically sensitive revenue category and is directly linked to private development activity. Based on projections provided by the Community Development Department, construction activity is anticipated to continue at higher than normal levels for FY 16-17, but lower than the

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peak levels experienced in 2014-2015. Revenue is estimated at \$4.4 million and \$3.7 million for 16-17 and 17-18 respectively, a 13% and 27% decrease for FY 16-17 and FY 17-18, respectively, compared to \$5.0 million in 2014-2015, which was the peak year. The revenue is expected to maintain at a stable level of approximately \$3.8 million per year in the out years through 2020-21.

The Community Development Fund expense budget is \$5.1 million for both FY 16-17 and FY 17-18, a decrease of 9 percent from last year primarily due to the completion of significant items such as the implementation of an integrated, electronic permit tracking system.

Community Development 5 Year Forecast

(in millions of dollars)						
	15-16	16-17	17-18	18-19	19-20	20-21
	YEP	Rec	Rec	Forecast	Forecast	Forecast
Beginning Balance	\$3.7	\$2.7	\$2.0	\$0.5	\$(1.1)	\$(2.8)
Revenues/Transfers In	4.3	4.4	3.7	3.7	3.8	3.8
Expenditures/Transfers Out	(5.3)	(5.1)	(5.1)	(5.4)	(5.5)	(5.7)
Ending Balance	\$2.7	\$2.0	\$0.5	\$(1.1)	\$(2.8)	\$(4.7)
Fund Balance/Expenditure (%)	52%	39%	10%	(20%)	(51%)	(82%)
Operating Margin	\$(1.0)	\$(0.7)	\$(1.5)	\$(1.6)	\$(1.7)	\$(1.8)

Water and Wastewater Funds

The Water and Wastewater Utilities are enterprise funds that derive all of their operating revenue from customer charges. As a result of the January 2016 rate studies, the Council approved a five year annual rates adjustment plan to ensure that public safety and health remain a priority, the integrity and reliability of these essential community assets can be maintained, and aging and inefficient infrastructure replaced. In addition, the approved rate adjustments provide proper reserve levels in accordance with Council policy and continue meeting legally required debt coverage.

With the approved rate adjustments, the City's Water revenue is forecasted to steadily increase from \$10.0 million in FY 16-17 to \$15.5 million in FY 20-21 and for Wastewater from \$10.4 million in FY 16-17 to \$12.2 million in FY 20-21. As summarized in the table below, the Water Operations is forecasted to continue tapping into its reserve to fund its operations in the short term and fall below Council's 30 percent reserve policy. By FY 17-18, revenues would begin to exceed expenditures and start generating surplus to allow the fund to begin building up its reserve to meet reserve fund targets set by City Council. The fund is forecasted to meet Council's reserve policy by FY 20-21.

Water Operating Fund 5 Year Forecast

(in millions of dollars)

	15-16 VED	16-17	17-18	18-19	19-20	20-21
	YEP	REC	REC	Forecast	Forecast	Forecast
Beginning Balance	\$2.7	\$1.5	\$0.8	\$1. 2	\$1.7	\$3.0
Revenues/Transfers In	8.8	10.0	12.2	13.3	14.5	15.5
Expenditures/Transfers Out	(10.0)	(10.7)	(11.8)	(12.8)	(13.2)	(14.8)
Ending Balance	\$1. 5	\$0.8	\$1.2	\$1.7	\$3.0	\$3.7
Fund Balance/Expenditure (%)	15%	7%	10%	13%	23%	25%
Operating Margin	\$(1.2)	\$(0.7)	\$0.4	\$0.5	\$1.3	\$0.7

Unlike the water fund, the wastewater fund, including rate stabilization and system replacement fund reserves, is projected to have a healthy beginning fund balance of approximately \$8.2 million. Also, unlike the water fund, the drought conditions that have significantly impacted the water fund due to reduced water consumption have had a minimal impact on the wastewater fund because rates are set from a three month average of water consumption during the winter months, which is typically the lowest period of water consumption. As a result, the Council has made the determination that the previously adopted 3.5% rate adjustment that would have gone into effect January 1, 2016 for wastewater not be implemented. The Council has approved nominal rate adjustments over the next five years.

Wastewater Operating Fund 5 Year Forecast

(in millions of dollars)

	15-16	16-17	17-18	18-19	19-20	20-21
	YEP	REC	REC	Forecast	Forecast	Forecast
Beginning Balance	\$4.3	\$2.9	\$2.6	\$2.7	\$2.8	\$2.9
Revenues/Transfers In	10.1	10.4	10.8	11.3	11.7	12.2
Expenditures/Transfers Out	(11.6)	(10.6)	(10.7)	(11.2)	(11.6)	(12.1)
Ending Balance	\$2.9	\$2.6	\$2.7	\$2.8	\$2.9	\$3.0
Fund Balance/Expenditure (%)	25%	25%	25%	25%	25%	25%
Operating Margin	-\$1.5	-\$0.2	\$0.1	\$0.1	\$0.1	\$0.1

Housing

Even though several years have passed since the dissolution of Redevelopment Agencies (RDA) by the State of California, the City's Housing program is still dealing with the loss of \$4 million in annual funding to support the rehabilitation and development of affordable housing in Morgan Hill. These housing funds were one of the significant cornerstones of the City's very successful housing program, and made possible most of the City's housing programs.

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The revenue needed to fund the City's housing programs is now directly aligned with the health of two funds: the Housing Mitigation Fund (Fund 236), which is infused with payments from residential developers who opt to pay the Below-Market-Rate (BMR) in-lieu fee instead of building BMR units, and the former RDA Housing Fund (Fund 255), which will receive continuing program income from the Agency's legacy projects and assets, as well as Supplemental Educational Revenue Augmentation Fund (SERAF) loan repayments, which are expected to be completed over a five year period.

With a projected \$6.7 million fund balance to start FY 16-17, the City has a healthy fund balance to continue its active housing program for the short term, though the long term outlook is less favorable. Because of this, we are actively participating in discussions to leverage regional resources with partners throughout the county, region, and state. In addition, the City Council will be holding affordable housing policy workshops in May and June to discuss the Council's priorities and policies.

Park Maintenance Fund

Morgan Hill funds its park maintenance activities from the City's Park Maintenance Fund. The revenue for this fund is derived from the City's Residential Development Control System (RDCS) process and represents "voluntary" payments that assist developers in gaining points for housing allocations. When this fund was established more than 10 years ago, the goal was to "endow" park maintenance so that it would not rely on the General Fund. However, to make this a reality, the fund would need to grow to at least \$30 million so the annual interest would cover the cost of park maintenance expenses. Today, this fund has a balance of approximately \$5.4 million.

Since this laudable goal would take many years to achieve, the Council decided to pay for park maintenance directly from this fund and then augment its funding sources through a \$200,000 annual contribution from the General Fund. The Recommended Biennial Budget and subsequent forecast years assume this transfer.

Capital Improvement Program (CIP)

The proposed FY 16-17 through FY 21-22 CIP totals \$111.3 million. The primary project categories include 1) Parks and Recreation (\$20.9 million), 2) Public Facilities (\$6.7 million), 3) Storm Drainage (\$6.1 million), 4) Streets & Roads (\$16.8 million), 5) Wastewater (\$45.0 million), and 6) Water (\$15.7 million).

FY 16-18 CIP is appropriated as part of the FY 16-18 Biennial Budget approval and it totals \$57.9 million. Some of the project highlights include the following:

1. Downtown Parks and Trails (\$4.1 million): Create parks and trails in the Downtown that are integrated as part of Downtown revitalization.

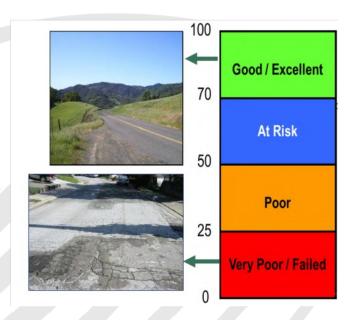
- 2. Library Expansion (\$3.4 million): Design and construction for the expansion and improvement of the Morgan Hill Library that includes space modification and improvements.
- 3. Pavement Rehabilitation Program (\$3.3 million): Ongoing program to address the City's pavement rehabilitation needs (see additional information in next section).
- 4. Hale Avenue Extension (\$3.9 million): The extension would provide relief for congestion along Monterey Road through the Downtown and relief for the residential areas west of the Downtown. It is important to note that the majority of project funding will need to be secured prior to commencing construction.
- 5. Sewer Plant Improvement (\$1.3 million) and Sewer Plant Expansion Project (\$2.0 million): These projects are for the City's 41.9 percent share of the improvement and expansion costs at the South County Regional Wastewater Authority (SCRWA) treatment plant which is co-owned with the City of Gilroy.
- 6. New Well Property/Construction (\$2.0 million) and New Water Reservoirs (\$2.7 million): New water wells are required to meet the City's water supply needs as Morgan Hill grows and to provide the necessary reliability during drought conditions. New reservoirs are needed to increase storage capability and assist meeting peak demand levels.

Public Infrastructure

In Morgan Hill, consistent with other California cities, there is a need for additional public investment in streets, parks and landscape, and public building infrastructure. The City recognizes that ongoing revenue is insufficient to fund these vital community assets at a sustainable level. The condition of the publicly owned infrastructure (especially streets) is deteriorating and the deferred maintenance backlog is increasing. The expense to repair these assets grows as each year passes so it is fiscally responsible to address this issue now.

Through the development of the public *Infrastructure Report* in November 2014, it was determined that the City has an annual funding gap of approximately \$5.8 million for its streets, parks, and public facilities infrastructure maintenance.

More specifically for its streets, the City uses the industry standard Pavement Condition Index (PCI) to evaluate street condition and has a goal to have the PCI of 70+. Since 2012, the City's PCI has dropped from 76 to 67 and is now considered "at risk." The current level of funding will result in further PCI decline. The *Infrastructure Report* identified a \$4.5 million annual shortfall in streets and roads maintenance funding to improve PCI into the low 70.



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As previously noted in the Budget Message, it is being recommended that the GF contribution for street improvement projects be increased from \$750,000 to \$1,000,000 annually in each of the next three fiscal years, bringing the total estimated investment in the City's pavement rehabilitation and safety program in the Biennial Budget to \$4.0 million, including gas tax funds and a grant. However, unless new revenue sources can be obtained in future years, the CIP includes a total of only \$1.8 million (or \$0.6 million each year) for fiscal years 19-20 through 21-22 as shown below.

	2016-17	2017-18	2018-19	2019-20	2020-21	2021-22
Pavement Investment	\$2.7M*	\$1.3M	\$1.4M	\$.06M	\$0.6M	\$0.6M

^{*}Amount includes \$705,000 from several legacy assessment districts

To address this reality, the City Council conducted a study session in July 2015 entitled "Best Practices Used by Successful Cities in Preparing for Potential Ballot and/or Revenue Enhancement Measures." At the conclusion of the study session, Council directed staff to engage the community on quality of life services and fiscal issues. Additionally, a global overview of the timing of presenting potential ballot or revenue solutions should reflect the community's perspective. In July 2016, staff will provide the Council with a report on the community's priorities. At that time, the Council will consider if it should ask the community to consider options for funding its quality of life priorities. It is important to note that the Council has yet to make this decision and no new revenues are assumed in the recommended budget or five year forecast.

Personnel

The City's full-time and part-time employees are one of the most important resources for the delivery of its high quality services. Annual investments in personnel account for approximately \$33.5 million or 26 percent of organizational wide expenses in FY 16-17 and \$34.9 million or 28 percent in FY 17-18. Of this dollar amount, 67 percent is related to salaries and the remaining 33 percent is attributed to benefits (health insurance, retirement, etc.). As a percent of total costs, Morgan Hill continues to contain its personnel expenses due to the fact that it has a long and successful history of working with other organizations to collaboratively deliver services; most notably, with the YMCA for recreation services, Cal Fire for fire/emergency medical services, and the City of Gilroy for wastewater services. This results in lower personnel costs now and into the future, which are partially offset by an increase in current contractual services. This use of non-City personnel leads to no additional obligation for future employee benefits and retirement.

As a result of the 2013 labor negotiations, the Council adopted Management Resolution and Council-Appointed Officer contracts, all City employees now equally share any annual increases to the City's retirement (CalPERS) contribution rates. A continued special thanks to all employees is deserved for working collaboratively with the City. Their actions demonstrated their dedication and commitment to the Morgan Hill community and, as importantly, their understanding that fiscal sustainability into the future

requires the City and its employees to share the burden. This significant change has and will continue to positively impact the City's ability to meet the community's service level needs and should not go unnoticed.

The Council's Long-Term Labor Policy, Principles, and Strategies' Principle No. 4 – Fiscal Sustainability and Economic Climate states that "all compensation commitments must be made consistent with principles of fiscal sustainability and to ensure the City's long term success in achieving its mission." As part of this principle, "the City will strive to hire contract employees instead of full-time benefitted employees to allow for greater flexibility during periods of peak demand." Since adopted in 2011, the City has adhered to this principle throughout the organization and especially in development services. The City has contracted to augment its team in the planning, engineering, and building functions to ensure we have the necessary resources to satisfy the expectations of the development community.

Periodically, we review our short and long term needs to determine the resources necessary to provide quality and timely services. As part of the recommended budget, we are proposing that we transition from contract services to hiring City employees in two areas. This includes hiring a full-time Senior Project Manager to deliver CIP projects (and relieve the existing Senior Project Manager for land development from this responsibility) and a third Project Inspector. This approach is being recommended because we have determined that the workload in land development, CIP project delivery, and inspections will remain constant in the years to come.

Beginning in FY 16-17, the following personnel are being proposed to enhance services.

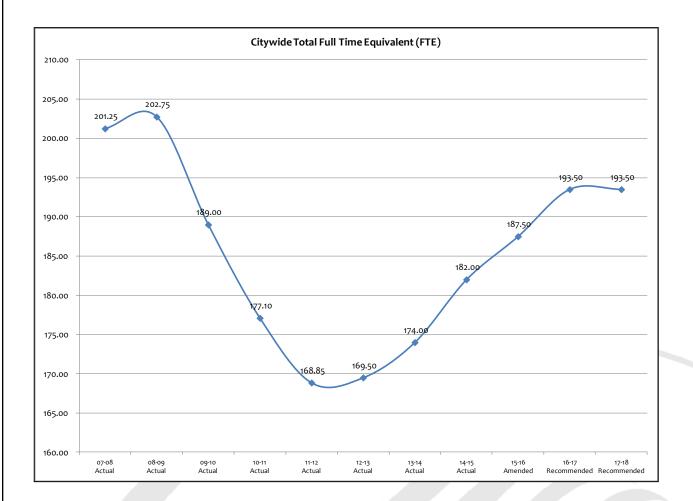
New Positions:

- Public Safety Dispatch Supervisor (1 FTE) in the Police Department to supervise and manage the day-to-day operations of the communication center and to ensure the center's operational effectiveness
- GIS/Land Use Data Administrator (1 FTE) in Community Development responsible for the design, operation, and administration of Citywide GIS infrastructure
- Accounting Manager (1 FTE) in the Finance Division to enhance service delivery and internal control procedures
- Public Works Inspector (1 FTE) and Senior Project Manager (1 FTE) in the Public Works
 Department to deliver CIP projects and increase the level of resources dedicated to
 development services (entirely offset by reducing contractual services in a greater
 amount for each position).

 Municipal Services Assistant position (1 FTE) in the Building and Code Compliance Divisions

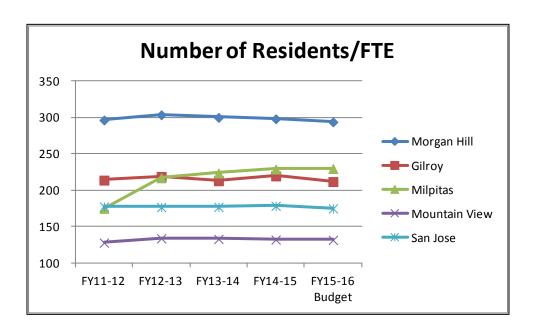
Reclassify Existing Position:

 Reclassify Assistant Finance Director to Director; Economic Development Manager to Director; Human Resources Manager to Director; and Council Services and Records Coordinator to Manager as each of these positions' responsibilities has evolved to a higher level to meet the needs of our community and customers.

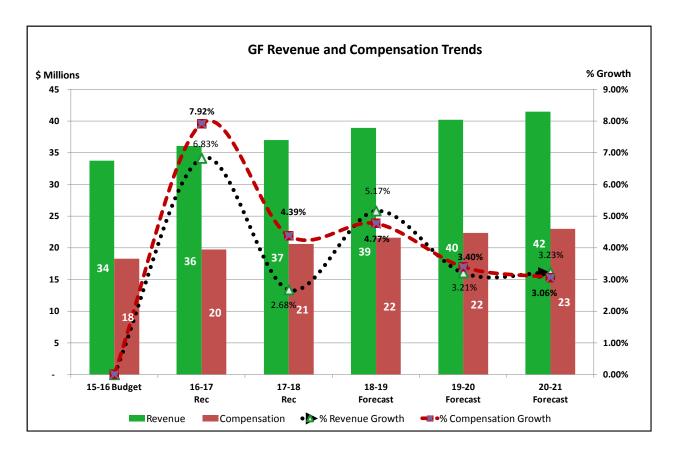


During the Great Recession, the City reduced approximately 34 positions or over 17 percent of its workforce. The City has managed to improve efficiencies, to do more with less staff, but this has continued to place a strain on the organization as the workload continues to be heavy and in many cases, increasing. While the rebounded economy has stabilized the City's General Fund budget, the City needs to enhance

and deliver its high level of service to meet our community expectations for public safety, development services, economic development, streets, parks, and recreation services, among others. With these additions, the City would now have a total of 193.5 FTEs. This is an increase of 6 FTEs from FY 15-16, though still below the 202.75 FTEs in FY 08-09. Even with the proposed additions, Morgan Hill continues to have the lowest number of FTE per capita (or highest number of residents per FTE) compared to a sample of surrounding cities as illustrated in the chart below:



In addition, the City has evaluated the increase in General Fund employee expenses with revenue growth to ensure that long term sustainability is achieved. As demonstrated below, projected growth in revenue and total General Fund employee compensation is equal in the final years of the five year forecast.



State of California Minimum Wage Increase

On April 4, 2016, California Governor Jerry Brown signed legislation that will raise California's minimum wage to \$15 per hour by 2022 from \$10 per hour currently. The minimum wage hike is estimated to have a fiscal impact to the City. The majority of the impact would be in the Community Services Department as it has the most part-time teammates providing front-line services at the recreation facilities such as Morgan Hill Dennis Kennedy Aquatic Center, Community Cultural and Center, and Centennial Recreation Center. In addition to the City-employed teammates, the minimum wage increase is expected to directly impact our YMCA partners which in turn would impact the City as the increase will impact the cost of YMCA partnership services paid by the City. The recommended budget includes the fiscal impact from the minimum wage increase of approximately \$718,000 over the five year forecast.

Employee Pension

The City provides retirement benefits to its employees through the California Public Employee Retirement System (CalPERS). Like most California cities, Morgan Hill provides a defined benefit pension to its employees. As seen in recent years, retirement costs have been fluctuating and will likely continue to experience upward or downward swings based on actual investment performance of CalPERS and changes in actuarial economic and demographic assumptions. In FY 16-17, the City's contribution for sworn police

officers is 35.963 percent of pay, lower than CalPERS required employer's contribution due to the 3.263 percent shared by our employees. The projected City's contribution for sworn police officers for FY 17-18 is 41.412 percent (37.056 percent City-paid and 4.356 percent employee-paid). These amounts are in addition to the employees' 9 percent of pay contribution to their own retirement. For all other employees, the employer's required contribution is 19.887 percent of pay (18.135 percent City-paid and 1.752 percent employee-paid—in addition to the employees' 8 percent of pay contribution to their own retirement) for FY 16-17 and 20.9 percent of pay is forecasted for FY 17-18 (18.642 percent City-paid and 2.258 percent employee-paid). The most recent CalPERS contribution rate projections for FY 20-21 are 46.51 percent for the Safety Group and 23.1 percent for the Miscellaneous Group, respectively. These figures have been included in the five year forecast, although as noted above, half of the increase is to be paid by employees under the pension cost-sharing agreement reached in 2013.

Furthermore, new State law became effective in January 2013 that changed CalPERS pensions for "new employees" that is known as PEPRA (Public Employee Pension Reform Act). Since the majority of Morgan Hill's employees are not impacted by these changes, any cost savings will be realized only over time as new employees (who are not current CalPERS members through another public agency) join the organization. Currently, 29 full-time employees (or 16 percent of the approved full-time positions) are classified as new employees for pension purposes. This is up from 21 full-time employees (or 11 percent) one year ago.

Summary

On behalf of the entire organization, I am proud to recommend the City's first two-year operating budget and six year CIP that reflects the City Council's and community's priorities and strives to enhance service levels. The City is able to maintain its positive General Fund financial condition due to the fiscally responsible actions taken in the prior fiscal years and by continuing to adhere to its sustainable budget strategy, prudently investing in service level enhancements as resources allow, and addressing areas of financial concern. As a result of the budget recommendation, the City will invest additional near term funding for maintaining its street and public facility infrastructure, enhance its public safety services, provide quality youth and senior services, continue to address its unfunded OPEB and pension obligations, and undertake many exciting and needed capital improvement projects. Moving forward, there are many signs that the Morgan Hill community will prosper. At the same time, the Council and staff will need to continue to engage our community. This community focused effort will allow us to meet our community's needs and maintain our high quality of life, so that Morgan Hill remains a highly desirable place to live, work, play, and do business.

Sincerely,

Steve Rymer

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City Manager